



Part I: The FY 2002 President's Budget



EXECUTIVE SUMMARY

Introduction to the Commission

Congress created the Commodity Futures Trading Commission (the CFTC or the Commission) in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The Commission's mandate was renewed and/or expanded in 1978, 1982, 1986, 1992, and 1995. In December 2000, the Commission was reauthorized by Congress and the President through Fiscal Year (FY) 2005 with the passage of the Commodity Futures Modernization Act of 2000 (CFMA).

The CFMA fundamentally transforms the Commission from a front-line regulatory agency to an oversight regulator. Although the Commission's approach to regulation will change, the CFTC's mission remains unchanged. The CFTC continues to be responsible for fostering the economic utility of futures markets by encouraging their competitiveness and efficiency, ensuring their integrity, and protecting market participants against manipulation, abusive trade practices, and fraud. Through effective oversight regulation, the CFTC enables the commodity futures markets better to serve their vital function in the nation's economy—providing a mechanism for price discovery and a means of offsetting price risks.

The OMB Budget Estimate for FY 2002 is \$70.4 million with 510 full-time equivalents (FTEs). This is a \$2.5 million or a 3.7 percent increase over the FY 2001 appropriation of \$67.9 million; the increase allows the Commission to finance approximately 510 FTEs—an estimated 57 fewer than in FY 2001.

The FY 2002 President's Budget

Breakout of \$70.4 Million Budget Estimate

The Commission is requesting \$70.4 Million in FY 2002;

\$67.9 Million is the base (FY 2001 Appropriation)

\$ 2.5 Million is the increase in FY 2002. . . .

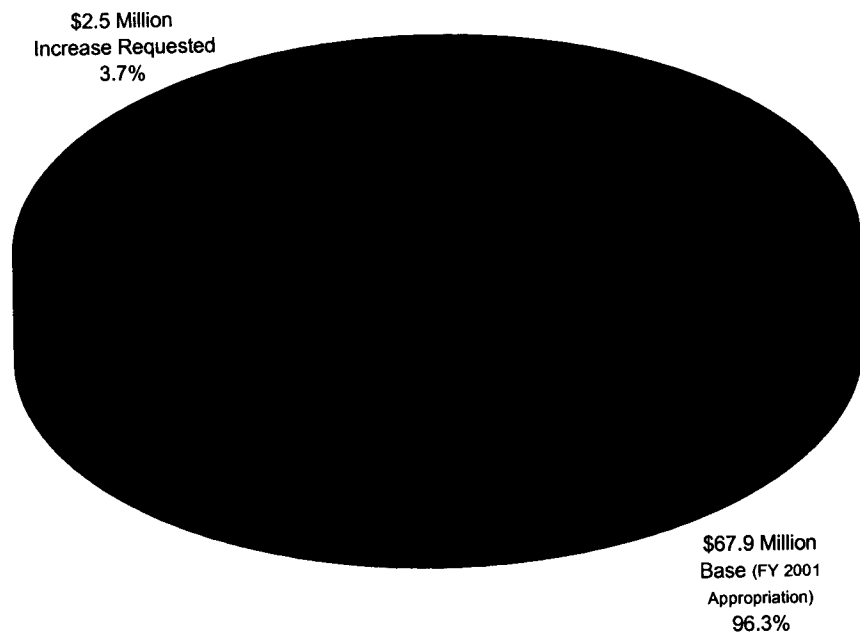


Figure 1: \$70.4 Million Budget Estimate

Breakout of \$70.4 Million Budget Estimate

By Program Activity

..... the \$70.4 Million Budget is allocated among five programs: Enforcement; Trading & Markets; Market Surveillance, Analysis & Research; Proceedings; and General Counsel. There is one support program: Executive Direction

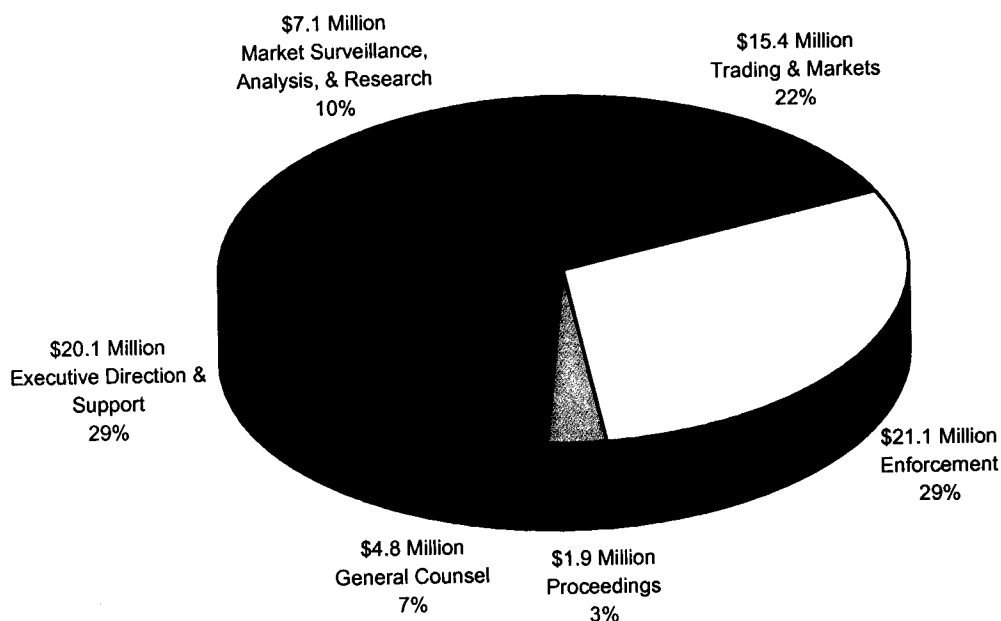


Figure 2: \$70.4 Million Budget Estimate by Program

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Breakout of \$70.4 Million Budget Estimate

By Object Class

. . . . approximately 72 percent of the CFTC's budget covers staff salaries and benefits

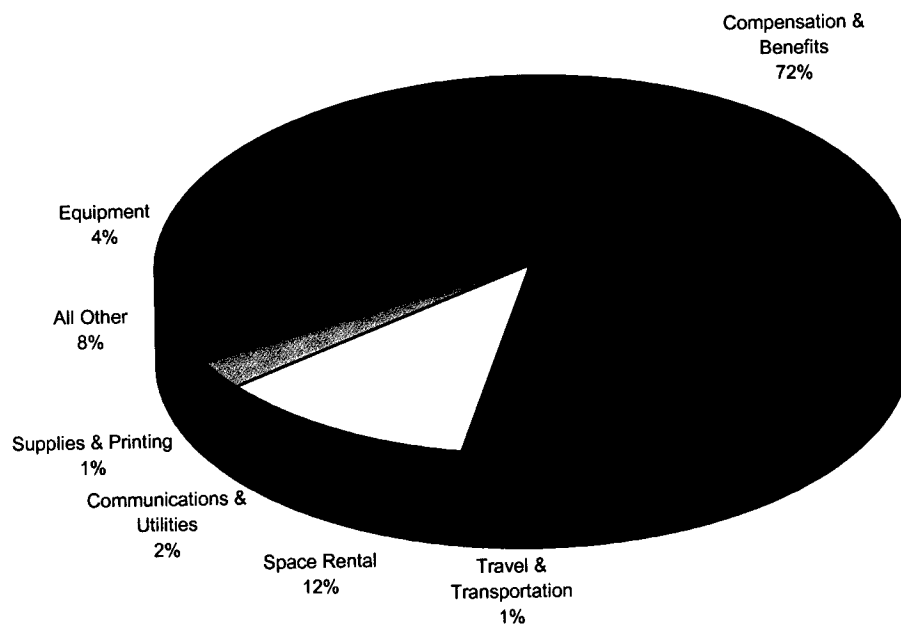


Figure 3: \$70.4 Million Budget Estimate by Object Class

Crosswalk From FY 2001 to FY 2002

	FY 2001 Estimate	FY 2002 Request	Change
Budget Authority (\$000)	\$67,850	\$70,400	\$2,550
Full-Time Equivalents (FTEs)	567	510	-57

<u>Explanation of Change</u>	FTEs	Dollars (\$000)
Increases: (Adjustments to FY 2000 Base)		
To provide for annualization of estimated Jan. 2001 3.7% pay increase		369
To provide for estimated January 2002 3.7% pay increase		1,238
To provide for increased pay for recruitment and retention of staff		967
To provide for within-grade increases		328
To provide for increased costs of benefits		1,451
To provide for use of permanent rather than temporary employees		495
To provide for 57 less FTEs	-57	-\$5,717
To provide for increased costs in other non-personnel services		3,419
Travel/Transportation (\$0)		
Space Rental (\$410)		
Communications/Utilities (\$87)		
Supplies/Printing (\$18)		
Information Technology Improvements (\$1,525)		
Other Services (\$239)		
Equipment (\$1,140)		
Total Increases	-57	\$2,550

Table 1: Crosswalk from FY 2001 to FY 2002



CFTC Mission Statement and Agency Goals

Mission Statement

The mission of the Commodity Futures Trading Commission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity futures and options, and to foster open, competitive and financially sound commodity futures and option markets.

Goal One

Protect the economic functions of the commodity futures and option markets.

Outcome Objectives

1. Foster futures and option markets that accurately reflect the forces of supply and demand for the underlying commodity and are free of disruptive activity.
2. Oversee markets which can be used effectively by producers, processors, financial institutions, and other firms for the purposes of price discovery and risk shifting.

Goal Two

Protect market users and the public.

Outcome Objectives

1. Promote compliance with, and deter violations of, federal commodities laws.
2. Require commodities professionals to meet high standards.
3. Provide a forum for effectively and expeditiously handling customer complaints against persons or firms registered under the Commodity Exchange Act.

Goal Three

Foster open, competitive and financially sound markets.

Outcome Objectives

1. Ensure sound financial practices of clearing organizations and firms holding customer funds.
2. Promote and enhance effective self-regulation of the commodity futures and option markets.
3. Facilitate the continued development of an effective, flexible regulatory environment responsive to evolving market conditions.
4. Promote markets free of trade practice abuses.

Breakout of \$70.4 Million Budget Estimate

By Agency Goal

. . . . the \$70.4 Million Budget is allocated among the agency's three Strategic Goals as follows

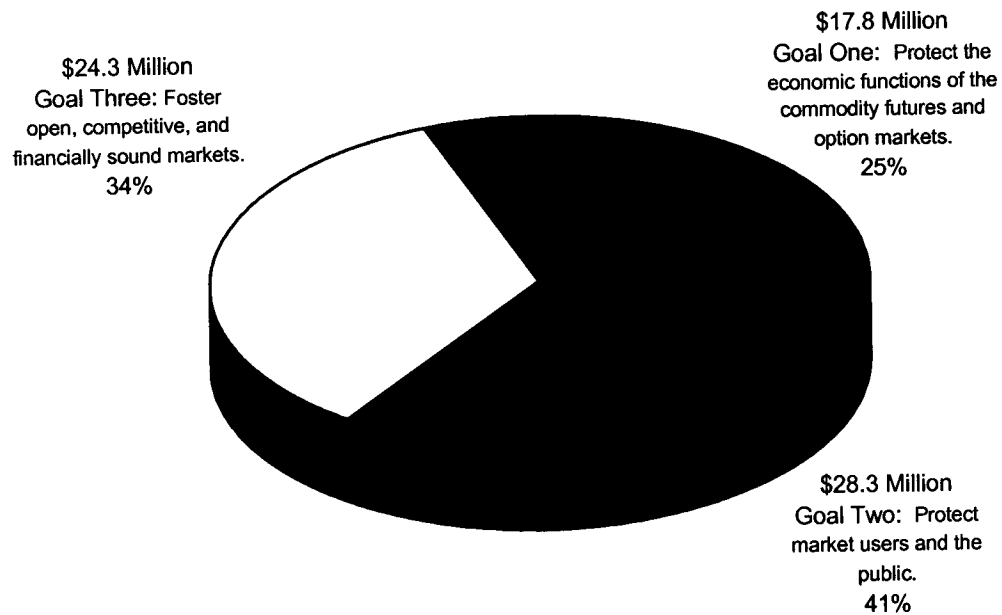


Figure 4: \$70.4 Million Budget Estimate by Agency Goal

Ranking of Commission Outcome Objectives

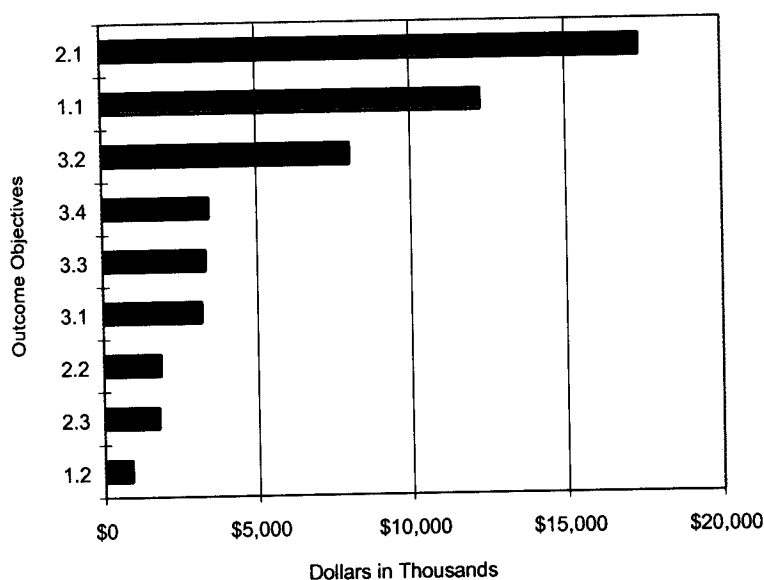


Table 2: Outcome Objectives by Dollars Budgeted

Outcome Objective	
2.1 ^{1/}	Promote compliance with, and deter violations of, federal commodities laws.
1.1	Foster futures and option markets that accurately reflect the forces of supply and demand for the underlying commodity and are free of disruptive activity.
3.2	Promote and enhance effective self-regulation of the commodity futures and and option markets.
3.4	Promote markets free of trade practice abuses.
3.3	Facilitate the continued development of an effective, flexible regulatory environment responsive to evolving market conditions.
3.1	Ensure sound financial practices of clearing organizations and firms holding customer funds.
2.2	Require commodities professionals to meet high standards.
2.3	Provide a forum for effectively and expeditiously handling customer complaints against persons or firms registered under the Commodity Exchange Act.
1.2	Oversee markets which can be used effectively by producers, processors, financial institutions, and other firms for the purposes of price discovery and risk shifting.

^{1/} Denotes Goal Two, Outcome Objective One. (See page 9.)

Significant Developments in the Past Year

Reauthorization and Regulatory Reform

FY 2000 witnessed a series of events, often on parallel legislative and regulatory tracks, that resulted in substantial revisions to the Commodity Exchange Act (CEA or the Act) and the transformation of the Commission from a front-line regulator to an oversight agency. The process began with legislative recommendations to Congress in November 2000 from the President's Working Group on Financial Markets (PWG) based on a study requested by the Chairmen of the Senate and House Agriculture Committees. The PWG urged Congress to exclude from the CEA transactions in financial instruments conducted over-the-counter (OTC) or electronically by financial institutions and other persons with demonstrated economic capacity. The PWG stated that statutory exclusions, together with other recommendations contained in its report, were needed to enhance legal certainty for OTC markets, to promote innovation, and to reduce systemic risk.

The PWG also asked Congress to grant explicit authority to provide appropriate relief consistent with the CFTC's determination of the public interest. After receiving the recommendation of the PWG, the Chairmen of the Senate and House Agriculture Committees asked the Commission to exercise its exemptive authority to fashion immediate relief for US futures markets, while Congress itself proceeded to consider legislation to reauthorize the CFTC, drawing significant guidance from the PWG's recommendations.

In response to Congress' request, Chairman Rainer formed a staff task force to create a new regulatory framework that would meet the Commission's public policy goals in a manner responsive to changing conditions in the US futures markets. To assist in this effort, the Commission held two public roundtables and one Agriculture Advisory Committee meeting in December 1999. To assure that the task force considered an array of perspectives, the staff met frequently with participants in the derivatives market, who represented a range of industry views. The task force proposed a framework establishing three kinds of trading facilities, subject to differing levels of Commission oversight. The task force also considered less sweeping regulatory relief for market intermediaries. A report outlining the new framework was submitted to Congress in February 2000. Its ideas provided further guidance to Congress as it proceeded with reauthorization legislation.

On a separate but related track, Commission staff began drafting rules to implement the new regulatory framework. Proposed rules were published for comment in June 2000. In addition to trading facilities, the comprehensive rules package addressed clearing, intermediaries and OTC transactions.

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In response to another request from Congress, staff from the commission and the Securities and Exchange Commission (SEC) began meeting to determine whether the trading of single-stock index futures should be permitted, and if so, under what conditions. The agencies reached an agreement in September 2000 and submitted it to Congress. The agreement provided for joint jurisdiction over single-stock futures and narrow-based stock index futures. Broad-based index futures remained under the CFTC's exclusive jurisdiction. The agreement also provided objective standards for determining whether a particular group of securities constitutes a narrow-based stock index.

Legislative and regulatory activity continued on parallel tracks through the remainder of the year. In November 2000, the Commission adopted final rules for comprehensive regulatory reform. This action was superseded the following month when Congress passed the President Clinton signed the CFMA. The CFMA repealed the ban on single-stock futures and implemented a joint regulatory framework for the new product; enacted the principal provisions of the Commission new regulatory framework; brought legal certainty to trading in OTC financial markets; clarify the CFTC's jurisdiction over certain aspects of the retail market in foreign exchange trading; and gave the CFTC authority to regulate clearing organizations. The CFMA also reauthorized the Commission for five years. Commission staff is now working to implement the CFMA both promulgating rules and conducting various studies (both independently and in coordination with other members of the PWG) mandated by the Act and working closely with the SEC and the Federal Reserve Board (FRB) to open the market to single-stock futures.

Implementation of the CFMA is now underway with several Commission approved proposed rules already published in the Federal Register. The proposed rules are available on the Commission Web site: <http://www.cftc.gov/opa/opapress01.htm>.

Enforcement

The primary goal of the Enforcement program is to police futures markets for conduct that violates the CEA or Commission regulations. Such misconduct undermines the integrity of the markets and the confidence of market participants. The Enforcement staff always looks for new ways to enhance their ability to detect and deter wrongdoing. In FY 2000, Enforcement staff recommended that the Commission take important actions using novel substantive and procedural approaches. The following matters are examples of significant developments in FY 2000:

Fraudulent Internet Solicitations. In FY 2000, the Commission demonstrated its ability and continuing commitment to respond when new methods, such as the Internet, are used as the means to cheat or defraud the public. Such methods pose a new threat because they enable malefactors to solicit business fraudulently from millions of people quickly and cheaply. To combat this threat, the Commis-

sion's enforcement program: 1) coordinated filings of enforcement actions to send an enhanced message to both wrongdoers and the public; 2) published a new Consumer Advisory; 3) participated in cooperative surveillance or "Internet surf days"; and 4) trained international enforcement agencies in the investigation and litigation of Internet-related fraud actions.

On May 1, 2000, the Commission announced the initial results of a coordinated enforcement initiative with the Federal Trade Commission (FTC) and SEC aimed at cleaning up Internet Web sites. The Commission targeted sites that fraudulently promote commodity trading systems and advisory services to the general public. As part of the initiative, the Commission filed and simultaneously settled the following 10 administrative enforcement actions: *In re Mohamed Najib Taybi*, CFTC Docket No. 00-12 (CFTC filed May 1, 2000); *In re Michael P. Calo d/b/a First Financial Trading*, CFTC Docket No. 00-17 (CFTC filed May 1, 2000); *In re Ellery Coleman d/b/a Granite Investments*, CFTC Docket No. 00-16 (CFTC filed May 1, 2000); *In re Paul B. Judd*, CFTC Docket No. 00-13 (CFTC filed May 1, 2000); *In re Oasis Publishing Corporation, et al.*, CFTC Docket No. 00-09 (CFTC filed May 1, 2000); *In re Eron Demian Read d/b/a New Age Trading Techniques, et al.*, CFTC Docket No. 00-14 (CFTC filed May 1, 2000); *In re Christopher Salter d/b/a Christopher Fenwick*, CFTC Docket No. 00-18 (CFTC filed May 1, 2000); *In re Ronald J. Schoemmell, et al.*, CFTC Docket No. 00-10 (CFTC filed May 1, 2000); *In re John B. Reily*, CFTC Docket No. 00-11 (CFTC filed May 1, 2000); and *In re Trendy Systems, LLC, et al.*, CFTC Docket No. 00-15 (CFTC filed May 1, 2000). On September 6, 2000, the Commission filed and simultaneously settled administrative enforcement actions in a second sweep against four additional promoters of commodity trading systems using the Internet, and filed a civil injunctive action against a fifth. *In re Stanley Edward Moore*, CFTC Docket No. 00-31 (CFTC filed Sept. 6, 2000); *In re Int'l Trading Systems, Ltd., et al.*, CFTC Docket No. 00-28 (CFTC filed Sept. 6, 2000); *In re Edward Martin d/b/a Black Gold Int'l*, CFTC Docket No. 00-30 (CFTC filed Sept. 6, 2000); *In re George Heffernan d/b/a Accutrader, et al.*, CFTC Docket No. 00-29 (CFTC filed Sept. 6, 2000); and *CFTC v. Alsafari*, No. C-00-3202 (N.D.Cal. filed Sept. 6, 2000). See "Internet Project Cases" found in Goal Two of the FY 2000 Annual Performance Report, page 201 for a description of these actions.

In some of these cases, respondents claimed that they personally profited by trading using their systems when in fact they either never traded or lost money trading; others claimed that customers had exceptional profits when in fact the customers had not made such profits or had lost money using the trading systems; some respondents did not make adequate risk disclosures; and others presented profitable hypothetical trades as actual trades and did not include the required disclaimer concerning the limitations of hypothetical trading. By filing these cases in coordinated Internet sweeps, the Commission achieved both specific deterrence in that the targeted Web sites were removed or cleaned up, as well as general deterrence in sending the message that fraud on the Internet will be prosecuted as vigorously as fraud that is committed through more traditional communications

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media.

The Commission's Internet Project also included a parallel, and equally important, public education initiative. On the same date that the first sweep cases were filed (May 1), the Commission also issued a Consumer Advisory warning the public about Web sites selling commodity trading systems that guarantee high profits with minimal risk. The Advisory warns consumers that commodity futures and options are typically high risk endeavors, that no computer trading system can guarantee profits, and that the hypothetical results used by many trading system promoters to advertise their systems can be unreliable. This Consumer Advisory is available on the Commission's Web site along with other Advisories concerning possible fraudulent activity in the commodity futures and options industry (<http://www.cftc.gov/opa/alerts.htm>).

In addition to its Internet surveillance program, during FY 2000 the Commission participated in two interagency "Internet Surfs." During the week of February 28, 2000, the Commission participated with law enforcement and consumer protection agencies from 27 countries in an interagency Internet surf. The Commission alone examined approximately 300 Internet Web sites and identified dozens for follow-up review. On March 28, 2000, the Commission participated in an international Internet surf day organized by the International Organization of Securities Commissions (IOSCO) that included the participation of 21 regulators in 18 countries. The sites identified for follow-up review by the Commission (and NFA) involved commodity futures and options in a variety of ways, such as: 1) computerized trading systems promising highly successful buy and sell signals; 2) trade recommendations based on seasonal trends in the prices of commodities like heating oil and gasoline; and 3) purported profit opportunities on commodities such as foreign currencies (or forex), precious metals, and stock indices.

On June 15-16, 2000, the Commission and the SEC jointly hosted a second Internet Surveillance Training Program for relevant enforcement staff from IOSCO's Working Party on Enforcement and Exchange of Information (WP4) members. The program was held at the Commission's Washington, DC headquarters. This training program brought together experts from regulators with Internet enforcement programs to provide instruction on areas such as the use of search engines for detecting securities offenses, Internet resources that identify authors of anonymous newsgroup postings and e-mail messages, and methods of preserving and authenticating electronic evidence. There was also a panel discussion on the organization of Internet surveillance and Internet enforcement programs. The Commission reached out to foreign as well as domestic authorities, such as the Federal Bureau of Investigation (FBI), to share knowledge and experiences at the training program. The program was attended by 22 participants from 19 different jurisdictions.

Fraud in Connection with Illegal Commodity Contracts. During FY 2000, the Commission's Enforcement program actively sought to protect the public from wrongdoers who fraudulently solicit customers

for what are purported to be financed speculative purchases of precious metals and other commodities but which are in fact illegal futures or options contracts. In FY 2000, the Commission brought two civil injunctive actions charging defendants with this type of misconduct. *CFTC v. IBS, Inc., et al.*, No. 3:00 CV 103-V (W.D.N.C. filed Mar. 13, 2000); and *CFTC v. National Bullion and Coin, Inc., et al.*, No. 00-6885 CIV-ZLOCH (S.D. Fla. filed June 28, 2000). See the "Illegal Instruments" section found Goal Two of the FY 2000 Annual Performance Report on page 212 for a description of these actions.

The Commission also issued a Consumer Advisory addressing this issue on July 5, 2000. This Advisory warns the public of companies that purportedly sell investments in precious metals and other commodities based on sales pitches fraudulently claiming that customers can make a lot of money, with little risk, by purchasing metal through a financing agreement. In the Consumer Advisory, the Commission warns that companies making such sales pitches often overstate profit potential while minimizing the risk involved; falsely claim that they are purchasing and storing the metal; and charge phony "storage" and "interest" fees. This Consumer Advisory has been posted on the Commission's Web site: (<http://www.cftc.gov/opa/alerts.htm>).

Fraudulent Trade Allocation. During FY 2000, the Commission successfully concluded related injunctive and administrative enforcement proceedings concerning a significant fraudulent trade allocation scheme involving trading for customers in U.S. Treasury bond futures and options contracts at the Chicago Board of Trade (CBT). In November 1999, the Commission filed a civil injunctive action against introducing broker Capital Insight Brokerage, Inc. (Capital Insight) and its president, owner, and associated person S. Jay Goldinger. The complaint alleged that Goldinger and Capital Insight purposefully failed to provide account numbers when they entered their orders with their futures commission merchant (FCM), Refco, Inc. (Refco). They provided the needed account numbers only after they knew the prices at which the trades had been confirmed, which allowed them to allocate profits and losses among their customers. They also allocated trades by transferring certain trades between customer accounts after the trades were executed. On November 12, 1999, the district court entered a consent order of permanent injunction (to which the defendants consented without admitting or denying liability) that permanently enjoined Capital Insight and Goldinger from further violations of the Act and regulations, as charged, and ordered them to pay \$6 million in disgorgement. *CFTC v. Goldinger*, No. 99-11543 WMB (C.D.Cal. filed Nov. 9, 1999).

Goldinger and Capital Insight entered their orders through Refco's phone desk on the floor of the CBT that was supervised by Refco salesperson Constantine Mitsopoulos. In September 1999, the Commission had filed an administrative complaint against Mitsopoulos, a registered floor broker (FB), and three phone clerks who worked for Mitsopoulos—Margaret Dull, Richard Marisie, and Lisa Budicak—based on their role in the fraudulent trade allocation scheme. In a series of orders issued in April and September 2000,

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the Commission accepted offers of settlement from Mitsopoulos and the phone clerks who, without admitting or denying liability, consented to the entry of orders finding that they failed to comply with order-taking and record-keeping requirements by not obtaining account identification information at the time they received orders from Capital Insight, and by changing the account identification on trades already assigned to a customer account. *In re Mitsopoulos, et al.*, CFTC Docket No. 99-17 (CFTC filed Sept. 30, 1999)

Unlawful Commission Kickbacks. In February 2000, the Commission issued an order simultaneously instituting administrative proceedings and accepting an offer of settlement from Sogemin Metals, Inc. (SMI), a registered introducing broker (IB), based on an unlawful and undisclosed commission arrangement involving SMI's brokering of futures and options transactions in metals for two Chilean clients, Corporacion Nacional del Cobre de Chile (Codelco), the world's largest producer of copper, and Empresa Nacional de Minería (Enami), another large producer. These transactions were executed by Sogemin Metals Limited (SML), SMI's parent company. The order found that SMI failed to disclose to Codelco and Enami that SML paid return commissions to a Cayman Islands company controlled by SML's Chilean agent, whose principals included individuals with close family connections to the head futures traders at Codelco and Enami. The order further found that this illegal scheme also involved kickbacks from these commissions to certain SMI senior employees and to the head futures traders at Codelco and Enami without the knowledge of the management of those companies. Without admitting or denying the Commission's findings, SMI consented to the entry of the order that directed SMI to: 1) cease and desist from further violations as charged; 2) pay a \$500,000 civil monetary penalty; and 3) comply with a series of undertakings to, among other things, adopt a strict monitoring procedure for commission rebates, revise SMI's internal procedures manual, and create an SMI compliance manual. *In re Sogemin Metals, Inc.*, CFTC Docket No. 00-4 (CFTC filed Feb. 7, 2000).

Innovative Markets

In FY 2000, the exchanges filed with the Commission 67 new futures and option contracts based on a wide variety of underlying physical products and financial instruments. Thirty of the contracts were submitted for Commission approval, while 37 were filed under the Commission's certification procedures, whereby exchanges certify that their contracts comply with the statutory and regulatory requirements. Several of the approved contracts represent innovative approaches designed to meet specialized hedging needs of producers and firms. For example, the Commission approved futures and option contracts based on US agency notes and barge freight rates. Also, the Commission reviewed futures and option contracts based on wood products produced in several regions in the US, as well as various livestock contracts and a regional electricity contract.

International Regulatory Cooperation

Information Sharing.

Singapore—On May 16, 2000, the Commission and the SEC signed an MOU with the Monetary Authority of Singapore (MAS) concerning consultation, cooperation, and the exchange of information. Recent Singapore legislation (issued March 2000) has granted the MAS authority to cooperate with foreign securities and futures authorities. The MOU provides a framework for information sharing, thereby facilitating cooperation in cross-border investigations of potential violations of securities and futures laws.

United Kingdom—On May 17, 2000, the Commission and the United Kingdom (UK) Financial Services Authority (FSA) entered into the *Arrangement on Warehouse Information (Arrangement)* enhancing the existing *US/UK Memorandum of Understanding on Mutual Assistance and the Exchange of Information* (dated September 25, 1991). The new arrangement is intended to facilitate exchanges of information between the Commission and the FSA for surveillance and enforcement purposes regarding deliverable commodities that are traded in both jurisdictions. The arrangement sets forth practical procedures for exchanges of information regarding the operations, stocks, and use of warehouses and may be triggered by either jurisdiction in connection with large unusual price movements in covered commodities. Moreover, the arrangement is designed to assure appropriate and confidential regulatory use of such information.

Exchanges initially affected by the new arrangement include the London International Financial Futures and Options Exchange (LIFFE) and the London Metals Exchange (LME) in the UK and the following US exchanges that trade related physical delivery commodities: the CBT, the Kansas City Board of Trade (KCBT), the Mid-America Commodity Exchange, the Minneapolis Grain Exchange (MGE), the New York Board of Trade (NYBT), and the Commodity Exchange Division of the New York Mercantile Exchange (COMEX).

Italy—The Commission and the Italian Commissione Nazionale per le Società e la Borsa (CONSOB) exchanged letters supplementing their main Memoranda of Understanding (MOU) in order to facilitate the listing of certain equity-based futures contracts.

In September 2000, OIA finalized a supplemental MOU with the CONSOB that facilitates, subject to each jurisdiction's national application procedures, remote electronic access by futures markets participants in one jurisdiction to regulated futures markets in the other jurisdiction by establishing reciprocal information sharing arrangements regarding the initial and ongoing fitness and financial solvency of such remote members.

In December 2000, the CFTC and the Commodities Exchanges Commission of the Ministry of the Russian Federation for Antimonopoly Policy and Support of Entrepreneurship issued a joint statement on technical assistance.

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- Hedge Funds. Actions involving responding to events in the financial markets related to the activities of hedge funds and other highly leveraged institutions (HLIs) continued to dominate a significant part of Commission activities in IOSCO. The Technical Committee's Task Force on Highly Leveraged Institutions issued a report containing recommendations intended to strengthen risk management processes, improve information flows, and identify areas that may warrant cooperation with other interested international parties, such as the Basle Banking Committee. Commission staff made significant contributions to the drafting of the internal report of the Working Group on Secondary Markets. The working group's report was referred to the Basle Banking Committee.
- "Best Practices." The Commission continued its active participation in the IOSCO task force on the implementation of the IOSCO report, *Objectives and Principles of Securities Regulation* (Core Principles) that were adopted as a statement of international "best practices." The Commission participated in drafting groups that prepared surveys for a high-level self-assessment on the extent to which the Core Principles have been implemented. In this capacity the Commission served as the prime drafter on the committee that developed the survey questionnaire on "the regulator" and "the secondary markets." The Commission also serves on a committee that is analyzing completed surveys.
- Year 2000 Preparedness. The Commission also actively contributed to IOSCO's activities to address challenges posed by the Year 2000 problem, including the development of a draft statement on Year 2000 testing and contingency planning.
- Working Party on Enforcement and Information-Sharing. During FY 2000 the Commission's Enforcement program continued to participate in IOSCO's Technical Committee's Working Party on Enforcement and Information-Sharing (WP4). WP4 considers issues and formulates recommendations relating to international assistance in the detection, investigation, and prosecution of securities and futures violations. During FY 2000, the Enforcement Division contributed substantially to the WP4 report on manipulation that was published at IOSCO's annual meeting in May 2000.
- Electronic Markets. The Commission continued to participate in IOSCO's work on examining the status of regulating electronic markets. The Commission contributed to a revision of IOSCO's 1990 statement of regulatory principles that was adopted by IOSCO in October 2000. The Commission played an active role in developing and collating a survey of current practices and participated actively in the drafting of new principles.
- Over-the-Counter Derivatives. Commission staff provided an updated analysis and commentary on its 1999 *Survey of the Regulation of Over-the-Counter Derivatives Transactions*, which examined the regulatory regimes in 16 jurisdictions across Europe, Asia, and North and South America. The survey was undertaken to

support the Commission's inquiries into the OTC markets and was intended to serve as a resource to make existing requirements more accessible and to facilitate further study of the treatment of OTC derivatives. In this regard, copies of the report were provided to the President's Working Group and to members of the IOSCO Technical Committee.

Electronic Trading Developments

The Commission is faced with an increasing number of important issues concerning the impact of technological changes on methods of transacting business on futures exchanges and a proliferation of designation applications for new electronic futures exchanges. The Commission has before it a number of different issues related to developments in electronic trading:

- Merchants' Exchange of St. Louis. The Commission designated the Merchants' Exchange of St. Louis, L.L.C. (MESL) as a contract market for the automated trading of deliverable Illinois Waterway and St. Louis Harbor barge freight futures contracts. MESL had not previously been approved by the Commission as a contract market in any commodity. MESL has contracted with the Board of Trade Clearing Corporation (BOTCC) to provide all clearance and settlement functions and with the National Futures Association (NFA) to perform several of MESL's self-regulatory organization (SRO) functions, including trade practice and market surveillance.
- FutureCom. The Commission designated, by orders dated March 13, 2000, FutureCom, Ltd. (FutureCom), a Texas limited partnership owned by the Texas Beef Group, as a new contract market for the automated Internet-based trading of cash-settled live cattle futures and options contracts. FutureCom is unique in that it is the first Internet-based futures exchange and every member is its own clearing member. Full margin for a position must be deposited with FutureCom before the order can be accepted by the system, and margin levels and position limits are tied directly to the creditworthiness of the member. FutureCom was approved to be its own clearinghouse while outsourcing certain clearing and settlement functions to a local bank pursuant to a cash settlement agreement. Staff are currently reviewing FutureCom's proposal of an alternate clearing bank for this purpose and will be monitoring the fulfillment of various conditions FutureCom must meet under the designation orders before commencing operations.
- BrokerTec Financial Futures Exchange. Staff are reviewing an application filed on May 8, 2000, by BrokerTec Futures Exchange, L.L.C. (BrokerTec) for designation as a fully automated contract market in short, medium, and long term US Treasury Bond Futures Contracts. The application provides that membership would be open internationally, based on such criteria as assets, capital, and creditworthiness. Clearing members would be re-

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quired to have adjusted net capital of not less than \$50,000,000. BrokerTec is wholly owned by BrokerTec Global, L.L.C., which was formed by a number of major international banks and other financial institutions to provide electronic inter-dealer brokerage for fixed-income markets. BrokerTec's designation application was published for comment in the *Federal Register* on June 9, 2000.

- *CBT-Eurex Alliance Rules.* On August 22, 2000, staff notified CBT that it could make effective immediately, without Commission approval, CBT's new rules for "e-cbot," a new trading platform using technology adapted from the electronic trading system employed by Eurex Deutschland, which is replacing the CBT's existing electronic trading system, Project A, as part of a strategic alliance between CBT, Eurex, and other affiliates. Users will be able to access e-cbot or Eurex through the same front-end application and terminal. The CBT submission reviewed by staff included rule changes, new implementation regulations, changes to the trade-matching algorithm, and revised surveillance arrangements.
- *CME Foreign Cross-Exchange Trading.* Staff allowed into effect a rule proposal from the Chicago Mercantile Exchange (CME) permitting link arrangements with various foreign exchanges (in addition to Marché à Terme International de France (MATIF), with which CME already had such an arrangement). Under the new rules, members of CME and a linked foreign exchange will be able to trade not just cross-exchange contracts listed on Globex, but all products accessible on either exchange's automated trading system. The rules of the exchange listing a particular contract will apply to all members of either exchange trading in that contract, and one exchange, selected by mutual agreement, will enforce those rules against all persons who trade that contract. The proposal was submitted in anticipation of a CME link arrangement with LIFFE, which was allowed into effect in December 1999.
- *Placement of NYMEX ACCESS Terminals in Singapore.* On May 1, 2000, staff notified the New York Mercantile Exchange (NYMEX) that its proposed linkage with Singapore Exchange Derivatives Trading Limited (SGX-DT) for the purpose of trading on NYMEX ACCESS, its automated electronic trading system, was approved and could be made effective immediately. ACCESS terminals are now located in England and are linked with SGX-DT, Sydney Futures Exchange (SFE), and Hong Kong Futures Exchange (HKFE). All linkages were approved under substantially similar qualifying factors.
- *Updated Version of NYMEX ACCESS Automated Trading System.* Staff allowed into effect the most recent version of NYMEX ACCESS, the NYMEX electronic trading system, developed to update the old ACCESS electronic trading system, originally approved by the Commission in 1992. The new version of ACCESS includes a "credit checking" function, allowing clearing members to take a

more proactive approach to handling the financial risks associated with the trading activity of the accounts they clear, expanding the protections of the NYMEX ACCESS. The new version expands the system's "reasonability checks" function, which protects system users against inadvertent errors in order entry and expands capacity and other available functions.

- *CX Proprietary Trading Program.* Commission staff notified Cantor Fitzgerald Financial Futures (CX) that it would allow into effect a proposal to permit proprietary trading by a CX affiliate, CF Entity. The action was based on CX representations concerning the erection of a "Chinese Wall" between CX and any CF Entity before proprietary trading could be carried out.
- *Automated System for Buying and Selling Electric Power.* Staff issued a no-action letter permitting the operation and use of an automated system for buying and selling electricity for delivery in the future, without the system operator obtaining contract market designation pursuant to Section 5 of the CEA. The system enables commercial entities that meet specified eligibility requirements to buy and sell electricity for on-peak hours in one-month blocks, up to 12 months in advance of delivery. The transactions are the result of the anonymous matching of bids to buy and offers to sell electricity; establish binding, specific physical delivery obligations; do not allow parties to make cash settlement in lieu of delivery; and do not provide a contractual right to extinguish delivery obligations absent commercial necessity. The relief was granted on condition that the system operator monitor market activity; notify the Trading and Markets program if less than 75 percent of the total volume of electricity contracted on the system, measured on an annual basis and calculated at the end of each calendar month, is delivered; and maintain transaction and financial records and make those records and other information available to Commission staff upon request.

Exchange Developments

- *CME Demutualization.* The Commission approved of a CME proposal to convert CME from an Illinois not-for-profit membership organization to a Delaware for-profit stock corporation and issuance of an order transferring all of CME's current contract market designations to the new entity, the Chicago Mercantile Exchange, Inc. Although there are other for-profit futures exchanges, CME's proposal was the first demutualization plan of an existing exchange approved by the Commission. In preparing its recommendation, staff analyzed the potential impact of the plan on the ability of the new for-profit exchange to perform its self-regulatory responsibilities effectively, as well as the plan's impact on other current CME activities. The Commission's action was based on certain specified conditions relating to the self-regulatory functions of the exchange.

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- *NYMEX Demutualization*. The Commission approved a NYMEX proposal to convert the exchange from a New York not-for-profit membership organization into a Delaware membership company that is a subsidiary of a Delaware for-profit stock corporation, NYMEX Holdings, Inc. and the issuance of an order transferring all of NYMEX's current contract market designations to the new entity. NYMEX's proposal was approved subject to conditions similar to those imposed with respect to CME.
- *LCH/CME Cross-Margining Proposal*. Staff allowed the CME to put into effect without prior approval proposed CME rule amendments to facilitate a proprietary CME/London Clearing-house (LCH) cross-margining program which uses the so-called "two-pot" approach. The rule amendments would provide reduced margin requirements and net settlement obligations for program participants who trade eligible offsetting contracts based on the reduced risk associated with cross-margined positions. The program is similar to a proprietary "two-pot" cross-margining program between the New York Clearing Corporation (NYCC) and the Government Securities Clearing Corporation (GSCC), approved by the Commission in July 1999. However, because it involves clearing organizations in different nations, the CME/LCH program raised novel issues concerning insolvency in a transnational context.
- *Revision of Regulation 1.59: Insider Trading Restrictions*. The Commission adopted final rules that exclude salaried SRO governing board members and committee members, and the "functional equivalents" thereof, from the definition of "employee" for purposes of Rule 1.59. In addition, the Commission determined to exclude SRO consultants from the definition of "employee," and adopted several technical amendments to Rule 1.59 to clarify certain ambiguities in the rule's provisions.

Streamlining Reviews of Exchange Rule Changes

The CFMA modified the approval requirements for submissions of proposed rule changes by exchanges. Under these procedures, any rule (except for terms and conditions of contracts on agricultural commodities enumerated under Section 1(a)(4) of the Act) can be placed into effect on the business day after the Commission had received a submission for the rule. There would be no delay in the implementation of the rule to allow for prior Commission review. The submission for the rule would have to include: 1) the text of the rule or amendment, with redline, as applicable; 2) a brief explanation of the rule; 3) a description of any substantive opposition; and 4) a "certification" that the rule is not inconsistent with the Act or with Commission regulations.

Managed Funds

- *Exemption from CPO and CTA Disclosure, Reporting, and Record-keeping Requirements*. The Commission adopted amendments to

Rule 4.7 to add several categories of persons to the definition of "qualified eligible person" (QEP). Under Rule 4.7, commodity pool operators (CPOs) who solicit only QEPs and CTAs who advise only QEPs may claim exemption from certain otherwise applicable disclosure, reporting, and record-keeping requirements.

- Commodity Pool Exclusion. The Commission adopted amendments to Rule 4.5 to add plans defined as "church plans" under the Employee Retirement Income Security Act of 1974 to the types of employee benefit plans that are not construed to be commodity pools (and whose operators are not required to register as CPOs).
- Performance Data and Disclosure for CTAs. The Commission proposed amendments to Part 4 of the Commission's rules concerning the documentation, computation, and disclosure of CTA past performance information. The rules would simplify the record-keeping and computational requirements for CTAs who accept partially funded client accounts while providing for meaningful and focused disclosure to clients regarding the past performance of the CTA and the risks attendant upon trading on a partially funded basis.
- Profile Disclosure. The Commission proposed revisions to Rule 4.21 to accommodate NFA's Compliance Rule 2-35(d). NFA's rule would permit CPOs to deliver a profile document containing key information about the pool to prospective participants prior to providing the pool's Disclosure Document.
- Hedge Funds. The Commission proposed a rule that would require commodity pools with net assets over \$1 billion or total assets over \$3 billion to file quarterly financial reports that include quantitative risk information. This proposal is in response to a recommendation of the President's Working Group on Financial Markets to give greater transparency to the risks posed by large hedge funds.

Financial Integrity—Net Capital

- Withdrawal of Net Capital. The Commission adopted an amendment to Rule 1.17 that deletes the existing restriction on the withdrawal of equity capital from an FCM or IB that is based on a percentage of the amount of funds an FCM is required to segregate. This rule was adopted in light of other early warning capital standards and the degree of surveillance performed by SROs.
- Offsetting Customer Deficits in the Segregated Account with Readily Marketable Securities. Staff are preparing a proposed amendment to Rule 1.32 to permit an FCM to offset a customer deficit in the segregated account with readily marketable securities deposited by such customer. The rule amendment would expand no-action letters which limit securities that an FCM may use to offset cus-

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tomers deficits to US Treasury instruments and certain Canadian government debt instruments.

- *Capital Charge on Unsecured Foreign Broker Receivable.* The Commission proposed amendments to Rule 1.17 to expand the current exemption from the five percent capital charge for unsecured foreign broker receivables. The proposal would ease costs borne by FCMs that frequently transfer margin to and from foreign brokers in an effort to minimize the capital charges.
- *Subordinated Loan Agreements.* The Commission adopted amendments to Rule 1.17, which governs the capital treatment of subordination agreements. The amendments would ease the regulatory burden imposed on SROs, FCMs, and IBs by allowing SROs to rely on a securities designated examining authority's approval of any proposed subordination agreement, proposed prepayment of a subordinated loan, or reduction in such a loan.

Foreign Futures

- *Foreign FCMs and IBs Accepting Orders from Sophisticated US Customers.* The Commission adopted Rule 30.12 permitting certain foreign firms, acting in the capacity of FCMs and IBs, to accept and execute foreign futures and options orders directly from certain sophisticated US customers without having to register with the Commission.
- *Foreign Futures and Options Secured Amount.* The Commission revised its interpretation of the foreign futures or foreign options secured amount requirement set forth in Rule 30.7, clarifying that the requirement for FCMs to obtain an acknowledgement from a depository, with respect to the treatment of foreign futures and options customer funds, applies only to the treatment of funds by the initial depository.
- *Foreign Boards of Trade Automated Trading Systems in the US.* No-action letters were issued to the International Petroleum Exchange of London Limited (IPE) in November 1999 and to the Singapore Exchange Ltd., formerly known as Singapore International Monetary Exchange (SIMEX), in December 1999. A supplemental no-action letter was also issued to LIFFE in December 1999. In June 2000, a no-action letter was issued to HKFE, and in September 2000, a no-action letter was issued to OM London Exchange Limited (OMLX). A request from EUREX (Switzerland) for a no-action letters was pending as of the end of FY 2000. The Commission also issued a Statement of Policy in June 2000 indicating that foreign exchanges that had already received no-action relief could trade additional contracts upon notice to the Commission, obviating the need for subsequent no-action letters.

Oversight in the New Regulatory Environment

In the new regulatory environment under the CFMA, the Commission's oversight role will depend to an even greater extent than before

on review of: 1) SRO adherence to the core principles governing their compliance with the Act and Commission regulations; and 2) unusual market events that can reveal systemic problems and risks faced by SROs, and in particular by designated contract markets or registered derivatives transaction execution facilities (DTFs). During the past year, staff contributed to effective Commission oversight of the futures markets by conducting several reviews.

- COMEX Gold Options Report. Staff issued a report in March 2000 concerning trading in COMEX gold options on September 28, 1999. On that date, the gold options market was severely strained by an extraordinary spike in volume, volatility, and price, accompanied by a more than 12-fold increase over the normal number of trades processed. This resulted in significant problems in the execution, clearing, and settlement of customer orders. Staff reviewed these events in detail to determine whether orders were received, executed, and cleared in accordance with exchange trading rules, whether systemic problems were revealed, and what corrective steps should be taken to ameliorate the impact of such market conditions should they recur. The report recommended, among other things, that COMEX adopt or upgrade various computer technologies for processing and recording gold options trades; hold special sessions to resolve trade processing problems in such situations; and develop a mechanism to determine the extent and location of mis-cleared trades in high volume situations.
- CBT Trade Practice Surveillance and Disciplinary Programs. Staff issued a rule enforcement review report on the trade practice surveillance and disciplinary programs of the CBT. Staff found that the CBT maintained adequate trade practice surveillance and disciplinary programs, conducting thorough, well-analyzed, and adequately supported trade practice investigations and in most cases imposing adequate sanctions. The report noted that use of the CBT's Sophisticated Market Analysis Research Technology system had significantly enhanced the CBT's trade practice surveillance capabilities. Staff found that the CBT continued to have problems with delays in completing trade practice investigations and, thus, recommended that the CBT focus substantial attention on timely completion of investigations in order to achieve significant improvements in timeliness. Staff also recommended improvements in particular aspects of the CBT's trade practice surveillance and disciplinary programs.
- KCBT Market Surveillance, Audit Trail, Trade Practice Surveillance, and Disciplinary Programs. Staff conducted a rule enforcement review and issued a report on the market surveillance, audit trail, trade practice surveillance and disciplinary programs of the KCBT. While the report noted that KCBT maintains an adequate market surveillance program and audit trail system, staff recommended that KCBT treat "No Quote" errors as trade timing errors subject to the exchange's summary disciplinary program. Staff also noted that KCBT's trade practice surveillance and disciplinary programs were adequate, but recommended that the ex-

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change impose penalties for substantive trading violations of an amount significant enough to address the seriousness of the violation and to serve as an effective deterrent.

- *NYMEX Trade Practice Surveillance, Audit Trail, and Disciplinary Programs*. Staff conducted a rule enforcement review and issued a report on the trade practice surveillance, audit trail, and disciplinary programs of NYMEX. The report noted that NYMEX maintains an adequate trade practice surveillance program and audit trail and record-keeping program. Although NYMEX also maintains an adequate disciplinary program, staff recommended that the exchange order members to pay restitution to injured customers in all disciplinary dispositions where the amount of customer harm can be determined. Staff also recommended that the exchange disclose a subject member's prior relevant disciplinary history when the case is presented to any disciplinary committee for consideration of sanctions.
- *Klein & Company Futures, Inc.* This FCM failed as a result of a failure of a major customer to meet an account deficit. Commission staff worked with representatives of Klein, NYBT, NYCC, and NYMEX to have customer cash and securities returned to customers. The staff are preparing a report to the Commission analyzing the events surrounding the failure and making recommendations for prevention of such events in the future.

Year 2000 Preparedness and Compliance

During early FY 2000, the Commission's IT staff continued its preparations for the Year 2000 rollover. As a result of good project management and risk assessment by all involved, the Commission's internal transition to 2000 was uneventful. Externally, the Commission was extensively involved in domestic and international Year 2000 preparation. Commission staff designed and executed a comprehensive plan for monitoring and addressing Year 2000 developments during the millennium transition. In part as a result of Commission efforts, the United States futures industry did not experience any material Year 2000 problems.

Information Technology Assessment

During FY 1999, the Commission contracted with Electronic Data Systems for an independent assessment of the Commission's information technology program. The assessment was conducted between January and June 2000, with a report issued in July 2000.

The report included a number of specific recommendations including Office of Information Resources Management (OIRM) organization structure changes, planning and management procedure modifications, including reestablishment of an Information Technology (IT) Strategic Planning body, with enhanced management involvement, staffing and training policies including a staff increase from 35 to at least 58 FTEs, an increase of at least 23, and implementation of staff skill requirements based upon the CIO Council Core Competencies framework, infrastructure changes including an enhanced informa-

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tion security program, and reengineering of the change management process.

A number of the changes can be implemented with existing resources. The Commission has initiated these efforts. This effort includes modifying the OIRM organization to support the required changes and reestablishing an IT strategic planning body with executive level involvement.

Other changes are predicated on a very substantial increase in the resources available for the information technology program. Some of this increase can be found within Commission resources. Six positions have been identified that the Commission has reallocated for IT. Beyond this, the Commission must seek additional resources if it is to implement the critical recommendations of the IT assessment. The Commission sought authority for ten additional positions in FY 2002. The President's Budget did not fund the full request. Budgetary support will only provide enough funding to support four additional FTEs in FY 2002, for a total of 45 authorized IT positions. After FY 2002, the Commission will seek authority and funding to increase the staff of OIRM to at least 58 FTEs.

With the minimum recommended staffing the Commission will be better positioned to complete the implementation of the recommended changes to its IT program.

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